Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:RFPH:[redacted]:POSTF-146474-02
[redacted]

date: September 4, 2002

to: Ralph Harris, International Team Manager (LM:CTM:1375)

from: Associate Area Counsel (LMSB), [redacted]

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subject: [redacted] **Inc. and Subsidiaries**
Debt-Equity Issue Regarding Advance to [redacted] **Subsidiary**

This memorandum addresses the second of two debt-equity issues you asked our office to review. The issue addressed herein concerns a transfer of funds by [redacted] Inc. [redacted] to its [redacted] subsidiary, [redacted]. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

This memorandum may contain privileged information. Any unauthorized disclosure of this memorandum may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

QUESTION

In transferring the equivalent of $[redacted] in [redacted] to [redacted] in [redacted] and [redacted], did [redacted] loan the amount to [redacted] or contribute the amount to [redacted]'s capital?

CONCLUSION

Overall, you have a reasonable basis for treating the transfer as debt based on the available facts, but we caution you that many of the factors support treating the transfer as equity. We encourage you to get the information mentioned later in this memorandum in order to further support your determination or better understand your hazards.

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FACTS

[redacted] is a domestic corporation with headquarters in [redacted]. It is in the business of discovering, developing, manufacturing, and selling [redacted] products. It owns or controls many foreign subsidiaries or operations, including [redacted]. [redacted] is in the business of selling [redacted]

According to its corporate minutes through [redacted], [redacted] had authorized increases in its capital in the following amounts:

Year	Amount	Year	Amount
[redacted]	[redacted]	[redacted]	[redacted]
			[redacted]

[redacted] reported this total capital of approximately [redacted] in audited financial statements for fiscal years ending November [redacted] through November [redacted].

During [redacted] and [redacted], [redacted] received from [redacted], or the equivalent of $[redacted]. [redacted] received the [redacted] in the following six payments:

[redacted]	[redacted]
	[redacted]

[redacted] received the first payment pursuant to a Memorandum of Agreement with [redacted] dated [redacted] [redacted] received the other [redacted] payments pursuant to [redacted] additional agreements, each of which modified the Memorandum of Agreement. In the original Memorandum of Agreement, [redacted] [redacted] and [redacted] agreed to the provisions as summarized below.

- [redacted]
- [redacted].
- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

- [redacted]

In the [redacted] agreements that modified the Memorandum of Agreement, [redacted] and [redacted] increased the advance [redacted] times in increments of [redacted], modified the annual interest payment to account for the average advance and weighted average interest rate, and increased the limit for the annual interest payment by [redacted] percent for each additional [redacted] included in the advance, thus increasing that limit by the end of [redacted] to [redacted] percent.

[redacted] referred to the [redacted] payment of the advance as debt in its corporate minutes: "[redacted]." [redacted] referred to the next [redacted] payments as debt using similar language. For the last [redacted] payments, however, [redacted] removed the reference to a loan in its corporate minutes: "[redacted]."

[redacted] treated the advance as debt in its audited financial statements for fiscal years ending November [redacted] and November [redacted]. In its balance sheets, [redacted] reported the advance as "[redacted]." In attachments to the balance sheets, [redacted] characterized the advance as a "[redacted]." The audited income statements show no detail regarding the advance, but other evidence shows that [redacted] accrued interest expense in the amounts of [redacted] and [redacted] for fiscal years ending November [redacted] and November [redacted] respectively. The available evidence does not show whether [redacted] made annual interest payments. Nor does it show how [redacted] used the advance. [redacted] did not establish a sinking fund for the advance.

In contrast, [redacted] treated the advance as equity. In its financial books covering calendar years [redacted] and [redacted], [redacted] decreased a cash account by about $[redacted], in total, and increased an investment-in-subsidiary account by the same amount. In its income tax returns for [redacted] and [redacted], Forms 5471, [redacted] reported the financial condition of [redacted] but reclassified the way in which that company reported the advance. According to [redacted] it used U.S. generally accepted accounting principles to reclassify the advance from debt to equity. [redacted] reversed [redacted]'s accrued annual interest payments through retained earnings. [redacted] attached to its [redacted] and [redacted] tax returns a statement disclosing that the advance was being treated as equity for U.S. tax purposes and debt for [redacted] purposes. [redacted] reported no interest income on the advance in these returns. [redacted] did not mention the advance in its corporate minutes for [redacted] through [redacted].

After suffering a loss is [redacted], [redacted] turned small profits in [redacted] and [redacted]. In its audited balance sheets and income statements for fiscal years ending November [redacted] through November [redacted], [redacted] reported the following amounts for the items listed below ([redacted]).

	[redacted]	[redacted]	[redacted]
Balance Sheet:			
Fixed assets	[redacted]	[redacted]	[redacted]
Stock	[redacted]	[redacted]	[redacted]
Receivables	[redacted]	[redacted]	[redacted]
Liquid assets	[redacted]	[redacted]	[redacted]
Other assets	[redacted]	[redacted]	[redacted]
Total assets	[redacted]	[redacted]	[redacted]
Debt [redacted]	[redacted]	[redacted]	[redacted]
Short-term debt	[redacted]	[redacted]	[redacted]
Equity (capital)	[redacted]	[redacted]	[redacted]
Current earnings	[redacted]	[redacted]	[redacted]
Loss carryover	[redacted]	[redacted]	[redacted]
Other liab. & eq.	[redacted]	[redacted]	[redacted]
Total liab. & eq.	[redacted]	[redacted]	[redacted]
Income Statement:			
Gross revenue	[redacted]	[redacted]	[redacted]
Net profit before tax	[redacted]	[redacted]	[redacted]
Net profit after tax	[redacted]	[redacted]	[redacted]

You have preliminarily determined that the advance was debt. You propose to increase [redacted]'s interest income for [redacted] and [redacted] by an arms-length interest charge on the advance in the amounts of $[redacted] and $[redacted], respectively. You determined the interest rate by using annual average lending rates found in International Monetary Fund, International Financial Statistics

Yearbook ([redacted]) ([redacted]% and [redacted]% for [redacted] and [redacted], respectively). To these lending rates, you added a [redacted]% premium because the advance was unsecured and subordinate to other debt.

DISCUSSION

Whether a transfer of funds to a closely-held corporation is debt or equity depends on the facts and circumstances of each case. See Dixie Dairies Corp. v. Commissioner, 74 T.C. 476, 493 (1980). In resolving questions of debt versus equity, courts have identified and considered various factors. See, e.g., Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972) (13 factors); A.R. Lantz Co. v. United States, 424 F.2d 1330 (9th Cir. 1970) (11 factors); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968) (16 factors); see also Calumet Indus., Inc. v. Commissioner, 95 T.C. 257, 285 (1990) (summarizing the factors).

The Court of Appeals for the Fifth Circuit has identified many of these factors as follows: (1) the name given to the certificate evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments, i.e., whether the recipient of the funds can repay the advance with reasonably anticipated cash-flow or liquid assets; (4) whether the provider of the funds has the right to enforce payment; (5) whether the provider of the advance gains an increased right to participate in management; (6) the status of the contribution in relation to regular creditors; (7) the intent of the parties; (8) whether the recipient of the advance is adequately capitalized; (9) whether there is an identity of interest between the creditor and the shareholder; (10) source of interest payments, i.e., whether the recipient of the funds pays interest from earnings; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the recipient used the advance to buy capital assets; and (13) whether the recipient repaid the funds on the due date. See Estate of Mixon v. United States, 464 F.2d at 402; see also Stinnett's Pontiac Serv., Inc. v. Commissioner, 730 F.2d 634, 638-40 (11th Cir. 1984); Laidlaw Transp., Inc. v. Commissioner, T.C. Memo. 1998-232.

The Court of Appeals for the Seventh Circuit, to which this case would be appealable, has not developed a similar list but has considered some of the same factors in various cases. See, e.g., Portage Plastics Co. v. United States, 470 F.2d 308, 312-13 (7th Cir. 1972); Sherwood Memorial Gardens, Inc. v. Commissioner, 350 F.2d 225, 229 (7th Cir. 1965); Charter Wire, Inc. v. United

States, 309 F.2d 878, 880-81 (7th Cir. 1962); Arlington Park Jockey Club v. Sauber, 262 F.2d 902, 905-06 (7th Cir. 1959).

These factors are not equally significant, nor are they always relevant. See Dixie Dairies Corp. v. Commissioner, 74 T.C. at 493-94. They only assist in answering the debt-equity question. See Fin Hay Realty Co. v. United States, 398 F.2d at 697. In distinguishing debt from equity, the Seventh Circuit has said that "the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event." Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182, 186 (7th Cir. 1942). According to the Tax Court, the ultimate question is, "was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?" Litton Business Systems, Inc. v. Commissioner, 61 T.C. 367, 377 (1973).

Below is a brief analysis of these factors in the context of this case.

1. The name given to the certificate evidencing the advance. The name may suggest debt or equity. See Estate of Mixon v. United States, 464 F.2d at 403. Here, the Memorandum of Agreement suggests neither. This factor is neutral.

2. The presence or absence of a fixed maturity date. A fixed maturity date tends to show the advance was debt. See Estate of Mixon v. United States, 464 F.2d at 404-05; Arlington Park Jockey Club v. Sauber, 262 F.2d at 906. In this case, the Memorandum of Agreement required repayment in 20 years. This factor favors debt.

3. The source of payments, i.e., whether the recipient of the funds can repay the advance with reasonably anticipated cash flow or liquid assets. Inadequate cash flow and liquid assets tend to show the advance was equity. See Estate of Mixon v. United States, 464 F.2d at 405. According to its financial statements for fiscal years ending November [redacted] through November [redacted], [redacted] appeared to be struggling. It had little in the way of liquid assets, it suffered a loss in [redacted], and turned only small profits in [redacted] and [redacted]. [redacted] might have had enough earnings to repay the advance if it continued to turn profits and if those earnings were put toward repayment, but it did not establish a sinking fund or otherwise reserve funds to repay the advance. Absence of a sinking fund tends to show the

advance was equity. Charter Wire, Inc. v. United States, 309 F.2d at 881. Without more information, this factor favors equity.

More detail about [redacted]'s financial condition may further support your determination. Try to get evidence showing that [redacted] had the resources and intent to repay the advance. For [redacted]'s fiscal years ending November [redacted] through November [redacted], get detailed statements of cash flow, and both short and long-term financial planning documents, including all budgets. In addition, get the income statements and balance sheets for [redacted]'s fiscal years ending November [redacted] through November [redacted], and November [redacted] through November [redacted]. It would also help to learn more detail about [redacted]'s business so that the financial statistics can be analyzed in better context. At this point, we only have a vague description of the business. In this regard, try to get information about [redacted]'s suppliers and customers, and about its involvement in discovering, developing, and manufacturing [redacted] products.

4. Whether the provider of the funds has the right to enforce payment. A fixed obligation to repay the advance tends to show the advance was debt. See Estate of Mixon v. United States, 464 F.2d at 405. Here, the Memorandum of Agreement required repayment in [redacted] years. This factor favors debt. On the other hand, the Memorandum of Agreement did not contain a provision for acceleration of repayment in case of default on the advance or interest. This favors equity. See Portage Plastics Co. v. United States, 470 F.2d at 313. In addition, the agreement allowed [redacted] to convert the balance of the advance into common shares of [redacted], without payment of a premium. This too favors equity. See Fin Hay Realty Co. v. United States, 398 F.2d at 696. Overall, this factor marginally favors debt.

5. Whether the provider of the advance gains an increased right to participate in management. Increased management rights tend to show that the advance was equity. See Estate of Mixon v. United States, 464 F.2d at 406. [redacted] owned and controlled [redacted] before and after the advance. This factor is neutral.

6. The status of the contribution in relation to regular creditors. An advance subordinated to general creditors tends to show the advance was equity. See Portage Plastics Co. v. United States, 470 F.2d at 313; Stinnett's Pontiac Serv., Inc. v. Commissioner, 730 F.2d at 639. Under the Memorandum of

Agreement, the balance of the unpaid advance and the balance of the unpaid annual interest payments were subordinated to any debts of [redacted] in a winding up or termination of [redacted]. This factor favors equity.

Other documents may provide more detail about the status of the advance. Try to get all agreements between [redacted] and its creditors entered into after [redacted] and before [redacted]. These agreements may have provisions regarding the advance. In addition, excluding the Memorandum of Agreement, try to get all agreements between [redacted] and [redacted] that mention the advance.

7. The intent of the parties. This depends on whether contemporaneous facts, not testimony given years later, show an unconditional obligation to repay the advances. <u>See</u> <u>Calumet Indus., Inc. v. Commissioner</u>, 95 T.C. at 288 (citing <u>Road Materials, Inc. v. Commissioner</u>, 407 F.2d 1121, 1124 (4th Cir. 1969)). Here, the contemporaneous facts as developed thus far do not decisively favor debt or equity. This factor is neutral in this case.

Other documents and testimony may help show the intent of [redacted] and [redacted] For [redacted]s fiscal years ending November [redacted] through November [redacted], get [redacted]'s and [redacted]'s corporate minutes, internal memoranda, and reports regarding the advance. With enough time in your examination cycle and cooperation from [redacted], you could also get testimony from the officers principally responsible for the advance.

8. Whether the recipient of the advance is adequately capitalized. Inadequate capitalization tends to show that the advance was equity. <u>See</u> <u>Estate of Mixon v. United States</u>, 464 F.2d at 408. Using the funds for items essential to the business also shows that the advance was equity. <u>See</u> <u>Charter Wire, Inc. v. United States</u>, 309 F.2d at 880. In this case, [redacted] seemed to have adequate capital, but the available evidence does not show how [redacted] used the advance. This factor marginally favors debt based on the available information.

More information regarding the use of the funds would help in analyzing this factor. Try to get detailed statements of cash flow for [redacted]'s fiscal years ending November [redacted] through November [redacted] (also mentioned in 3 above).

9. Whether there is an identity of interest between the creditor and the shareholder. Advances are more likely equity if

they are made by shareholders in proportion to stock ownership. See Estate of Mixon v. United States, 464 F.2d at 409; Charter Wire, Inc. v. United States, 309 F.2d at 881. [redacted] owned and controlled [redacted] before and after the advance. This factor is neutral.

10. Source of interest payments, i.e., whether the recipient of the funds pays interest from earnings. Payment of interest suggests that an advance is debt. See Estate of Mixon v. United States, 464 F.2d at 409. In this case, [redacted] did not make payments of the interest, at least through [redacted]. Furthermore, interest payable only out of net earnings before taxes suggests that the advance is equity. See Portage Plastics Co. v. United States, 470 F.2d at 313. Here, [redacted] was not required to make an annual interest payment exceeding [redacted] percent of its statutory income before taxes and the amount of interest. This factor favors equity.

Other documents may show the interest was later paid. Again, get the detailed statements of cash flow for [redacted]'s fiscal years ending November [redacted] through November [redacted]. Also get [redacted]'s financial accounting books for the accounts regarding the advance and the interest payable for [redacted]'s fiscal years ending November [redacted] through November [redacted].

11. The ability of the corporation to obtain loans from outside lending institutions. If the recipient of the advance can borrow from outside sources when it receives an advance, the advance is more likely to be debt. See Estate of Mixon v. United States, 464 F.2d at 410. Unless [redacted] received a loan from an independent lender in about the same amount and at about the same time, or applied for one but was turned down, you would need an expert opinion to know whether [redacted] could have received a $[redacted] loan from an outside source. This factor is neutral.

12. The extent to which the recipient used the advance to buy capital assets. An advance is more likely equity if used to purchase capital assets. See Charter Wire, Inc. v. United States, 309 F.2d at 880. The available evidence does not show how [redacted] used the advance. This factor is neutral based on the available information.

More information regarding the use of the funds would help in analyzing this factor. Try to get the information mentioned in 8 above.

13. Whether the recipient repaid the funds on the due date. A failure to repay indicates the advance was equity. See Estate of Mixon v. United States, 464 F.2d at 410. In this case, the advance is not due yet. This factor is neutral.

Overall, you have a reasonable basis for treating the advance as debt based on the available facts. [redacted] referred to the advance as a loan in its corporate minutes. It treated the advance as debt in its financial statements. It had sufficient capital at the time of the advance. It was required to repay the advance in [redacted] years. It might have had enough earnings to repay the advance if it continued to turn profits as it did in [redacted] and [redacted] and if those earnings were put toward repayment. And [redacted] had the right to enforce repayment.

On the other hand, we caution you that many of the factors support treating the advance as equity. [redacted] might not have had enough earnings to repay the advance. According to its financial statements for fiscal years ending November [redacted] through November [redacted], [redacted] appeared to be struggling. It had little in the way of liquid assets, it suffered a loss in [redacted], and turned only small profits in [redacted] and [redacted]. [redacted] did not establish a sinking fund for repayment of the advance. It was not required to make an interest payment exceeding [redacted] percent of its statutory income before taxes and before the amount of interest on the advance. It did not make payments of interest at least through [redacted]. The balance of the unpaid advance and the balance of the unpaid annual interest payments were subordinated to any debts of [redacted] in a winding up or termination of [redacted]. [redacted] could not accelerate repayment in case of default on the advance or interest. And [redacted] could convert the balance of the advance into common shares of [redacted] without payment of a premium.

We encourage you to get the information mentioned earlier in this memorandum in order to further support your determination or better understand your hazards.

Finally, we note that you based your adjustments on the annual average lending rates found in International Monetary Fund, International Financial Statistics Yearbook [redacted]. We believe that those rates are reasonable guides for the appropriate arms-length charge for interest. However, as you know, those rates would likely require refinement by an expert in the field after all of the relevant evidence is in.

We have not coordinated this advice with an Industry Counsel because the issue does not appear to be within the scope of the responsibility of any Industry Counsel. For questions regarding this memorandum, please contact [redacted] extension , (b)(6)

Associate Area Counsel (LMSB), [redacted]

By [redacted]

Attorney

cc: James C. Lanning, Area Counsel
Barbara Franklin, Senior Legal Counsel
[redacted], Associate Area Counsel
[redacted], Associate Area Counsel
[redacted], Associate Area Counsel (IP)